

TO: Files

CC San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Karyn Keese on May 10, 2006

DATED: May 10, 2006

On May 10, 2006, Sharon Blaskey and Michael Shapiro, in Willkie Farr & Gallagher LLP's capacity as counsel to the Audit Committee, interviewed Karyn Keese, the National Financial Services Manager of PBS&J, at the City Administration Building, 202 C Street in San Diego, in a conference room on the third floor. Ms. Keese was represented by Al M. De La Cruz of Manning & Marder and Susan Reaser, Staff Counsel of PBS&J. Johnny Giang and Tammie Davis from KPMG also attended the interview.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with Karyn Keese, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Ms. Blaskey began the interview by explaining the circumstances and purpose of the City of San Diego's (the "City") creation of the Audit Committee, noting that information obtained during the course of the interview would be used, if relevant, in the Audit Committee's eventual report. Ms. Blaskey explained that Willkie does not represent Ms. Keese and, thus, statements made during the interview are not covered by the attorney-client privilege. Nonetheless, we would be treating the information obtained during the interview as confidential, covered by the work-product privilege during the investigation, but any such privilege would likely be lost with the release of the Audit Committee's report. Ms. Blaskey asked that Ms. Keese keep the interview confidential. Ms. Blaskey further explained that, if requested, we would provide information from the interview to the SEC, the U.S. Attorney's Office or the City's outside auditor, KPMG, so it is important that Ms. Keese be accurate and truthful. Ms. Blaskey emphasized that Ms. Keese should seek clarification of any question at any time.

Background

Ms. Blaskey asked Ms. Keese to provide her work background. Ms. Keese said she has worked for the past four years for PBS&J, a large engineering firm based in Miami. At PBS&J, Ms. Keese serves as the National Financial Services Manager and works on financing studies, including water and sewer rate studies, as well as capital financing studies, asset valuations, and grants research. She received a B.S. in finance and accounting from the University of Virginia. Ms. Keese then became a finance manager for two sewer authorities, first working for the Encina Wastewater Treatment Plant from 1978 to 1983, and then for the

Monterrey Regional Water Pollution Control Agency from 1983-1988. In 1988, Ms. Keese began her own consulting business. She served as a financial consultant for the Participating Agencies (the "PA's") of the City of San Diego, and worked on budgets, audits, and studies. When the Metropolitan Wastewater Department (the "MWWD") did a Cost of Service Study (the "COSS") and made the decision to incorporate BOD into the rate structure, she said that the Mayor of San Diego formed a citizen's committee, the Stakeholders' Group (the "Group"), and asked Keese to sit on it.

Work for the PA's

Ms. Blaskey asked Ms. Keese to describe how she first came to work for the PA's. Ms. Keese said that she was formally hired by the PA's in 1998, once they had obtained a new contract with the City. Prior to that time she also had peripheral involvement with the PAs' response to the City's withdrawal of its secondary treatment waiver.

Ms. Blaskey asked Ms. Keese to describe the work she did for the City's PA's. Ms. Keese said she did the revenue plans for many PA's including Lemon Grove, National City, County of San Diego, Otter Dam, La Mesa, and Del Mar, and submitted the plans to the State. By the early 1990's, the City of San Diego, a regional agency, had to be in compliance with State requirements, so San Diego had to provide a revenue program. The individual PA's also had to show they had a revenue program that was in compliance. Each revenue plan of the PA's required State approval.

Knowledge of State Requirements

Ms. Blaskey asked Ms. Keese whether she is familiar with the State's requirements for grants and loans. Ms. Keese replied that she is familiar with the State's "fair and equitable" requirements because she dealt with EPA grants involving Encina and Monterrey. Under these requirements, all rate payers should pay based on their discharge. Ms. Blaskey asked Ms. Keese whether she was aware that COD/BOD needed to be incorporated into the rate structure to comply with the State's requirements. She was aware that COD/BOD was needed to meet the "fair and equitable" requirements, felt COD/BOD was a necessary requirement, and noted that it was common knowledge that the PA's were not being charged for BOD/COD. Originally, the PA's were only required to have suspended solids and flow in the rates. The need to implement BOD began when North City was built. North City needed to be built so Point Loma could do advanced primary treatment. The EPA accepted structures using only suspended solids from San Diego and the PA's in the early 1990's. She noted that the revenue program guidelines need to be followed to get State approval.

PA's Incorporation of COD

Ms. Keese was shown Exhibit 1, the 1988 Revenue Guidelines. Ms. Blaskey asked Ms. Keese how she first became involved with the COD issue pertaining to the PA's. Ms. Keese said she spoke with Hedy Griffiths regarding incorporating COD into the rate structure of the PA's. In 1990, the PA's allocated based on flow and SS, as did San Diego. Some PA's, like Del Mar, chose to allocate BOD in their rates earlier even though it was not required. Del Mar did so because its attorney interpreted the guidelines in such a way that Del Mar had to put BOD in its rates. Ms. Blaskey asked Ms. Keese if any PA, if it chose to, could incorporate BOD at

that time and if San Diego had to change its billing system to accommodate Del Mar. Ms. Keese said that any PA could have included BOD in 1990 and she did not know if San Diego had to change the billing for Del Mar based on Del Mar incorporating BOD.

Ms. Blaskey asked Ms. Keese why the PA's implemented COD before the City did. Ms. Keese said she did not know why, and did not know why there was a delay in implementing COD for the City.

Ms. Blaskey asked Ms. Keese how she first learned that the PA's needed to incorporate COD. Ms. Keese said first learned that Blair requested that the PA's incorporate COD, either in the form of a letter from Blair that was sent to the PA's or she was told so by San Diego, at that time. It was also at that time that she was consulted on including COD in the rate structure and prepared the revenue programs for the PA's, which involved calculating the number of users, estimating the flow, following the State guidelines, and allocating costs to the parameters necessary to develop the rate. Ms. Blaskey asked Ms. Keese how long it takes to develop a revenue program. She said it takes about one month to complete the technical part of the revenue program and then implementation is a variable amount of time because the plan has to be adopted by the municipal governing bodies of each PA. Ms. Blaskey asked Ms. Keese to describe her involvement with the City of San Diego during this period of time. Ms. Keese said she did not have much interaction with San Diego except to obtain estimates of costs to be charged to the PA's.

In the switch to incorporating an organics component to the PA's rate structure, Ms. Keese said that Montgomery Watson prepared a functional design cost allocation for the City which was used as a basis for a dialogue concerning the best allocation to use, in meetings between the PA's and San Diego. Ms. Keese felt the functional design method was a fair methodology that "everyone agreed on." She said the method allocates a percentage for O&M, capital, and debt service, and those percentages are passed on to the PA's from San Diego based on the allocation of the flow, SS and COD/BOD parameters. Ms. Blaskey asked Ms. Keese whether she heard of any disagreements concerning the methodology to be utilized and she said she was not aware of any. Ms. Blaskey asked Ms. Keese about the steps taken once the methodology was decided upon. Ms. Keese said revenue programs were prepared that utilized the functional design methodology, and were submitted to the State, though not reviewed by the City of San Diego since the City had no say regarding each PA's revenue program.

Ron Blair

Ms. Blaskey asked Ms. Keese to describe her relationship with Ron Blair. Ms. Keese said she was very familiar with Ron Blair. She said Blair was in the construction management division of the State and she first dealt with him on change orders when she worked on an Encina project in the late 1970's. When Frank Peters of the State Water Resources Control Board retired, Blair took over administering San Diego's loans. Ms. Blaskey asked Ms. Keese if she recalled alerting Blair in the early 1990's to the fact that the PA's were not incorporating COD in their rate structure. Ms. Keese did not recall alerting him to that fact. She also did not recall being consulted by the PA's regarding COD before 1998. She said that when San Diego requested that the PA's include COD, during the same period when the new contract was being negotiated between the City and the PA's, the PA's showed interest in doing so.

Ms. Blaskey asked Ms. Keese whether, in her experience with him, Blair strictly interpreted State Water Resources Control Board requirements. She said Blair interpreted the State guidelines strictly but was a "fair man." She said that if you did not use the guidelines, you had to do engineering studies to prove what you were doing was appropriate. She said she would expect to hear from Blair if there was a problem, and noted that Blair was "extremely tough" and "diligent" and even caught math errors she made in her revenue programs. She further stated that he did not deviate from the guidelines and "didn't just put the plan on his shelf and send a letter."

Ms. Blaskey asked Ms. Keese whether she had conversations with Blair regarding the City not using COD in 1998. Ms. Keese said she did not know who did. She recalled that she called Blair to let him know that the revenue programs for the PA's were coming and Blair called her with questions and comments. She then modified the revenue programs and he approved them.

Awareness of City Compliance

Ms. Blaskey asked Ms. Keese whether she knew that the City did not include COD in 1998. Ms. Keese said that she did but did not remember how she knew. She knew San Diego was working on incorporating COD and had hired a consultant to do a COSS but did not know if there had been a prior COSS. She believed the City's COSS was in process when the PA's implemented COD.

Metrowastewater Commission

Ms. Keese said that a Metrowastewater Commission (the "Commission") was formed under the 1998 agreement between the PA's and San Diego. The Commission was loosely supposed to be advisory to the City on wastewater matters that affected the PA's. The Commission was chosen by the governing bodies of each PA and there was a sub-committee of the Commission, Metrotac, which was a technical group that interacted with San Diego to review capital projects and financial matters so that the PA's would have input. Metrotac's recommendations would go to the Commission for ratification.

The Stakeholders' Group

Ms. Blaskey asked Ms. Keese to describe her involvement with the Sewer Cost of Service Stakeholders' Group. She said she was one of the members and was appointed by the Mayor. Bill Hanley asked her to serve because of her technical background. Ms. Blaskey asked Ms. Keese to describe the purpose of the Group. Ms. Keese replied that its purpose was to review the COSS, make recommendations to the City's consultants (Black & Veatch), and come up with a final recommendation on sewer rates for the Council. According to Ms. Keese, updating the COSS and including COD in the rates would form the basis for the City's new revenue program once approved by the Council. Ms. Blaskey asked Ms. Keese for her understanding of the status of the COSS at the time the Group was formed. She said that she understood by that time the COSS was completed but was brought to the Group as a draft. She did not know if there was a COSS prior to this one, but received this one in pieces at Group meetings, eventually receiving the full copy when it was finalized after the Group had completed its work.

Ms. Blaskey asked Ms. Keese if she served on any committees prior to serving on the Group. She replied that she had not, but now serves on the Public Utilities Advisory Council (the "PUAC") as a technical representative, appointed by the Mayor. Ms. Blaskey asked Ms. Keese to explain her role and responsibilities as a technical representative on the PUAC. She said she can attend all meetings but has no voting power. She also serves on the Water Budget and Rate Case Subcommittee (the "Water Subcommittee") and the Wastewater Budget and Rate Case Subcommittee (the "Wastewater Subcommittee"). The Subcommittees make recommendations to the PUAC.

Ms. Keese was then shown Exhibit 2, the Sewer Cost of Service Stakeholders' Group Final Report. Ms. Blaskey asked Ms. Keese to describe the dynamic of the Group. Ms. Keese replied that the Group included lay people and industry representatives, including SONY, planning groups, the restaurant association, Kelco, and the Catfish Club. Ms. Blaskey asked Ms. Keese whether the issue of implementing COD was discussed by the Group. She replied that there was no choice whether to adopt COD since it was a requirement by the State and had to be included, which she said Kahlie explained at the Group's first meeting. Bill Hanley told her that the City had to comply with the COD requirement as had the PA's, so the City was conducting a COSS to incorporate COD. Ms. Keese did not recall conversations with Blair in 2000 about the Group. Ms. Keese said that when the issue of COD was discussed by the Group, Kahlie constantly reminded everyone that there was a requirement to implement COD. Black & Veatch prepared a draft Stakeholders' Group Report and presented it over a series of meetings to the Group. The facilitator of the Group was Patricia Tennyson, who "kept things moving."

Kelco

Ms. Blaskey asked Ms. Keese to describe Kelco's involvement in the Group. Ms. Keese said that the dynamic of the Group included resistance by some to the inclusion of COD in the rates. Point Loma was not doing secondary treatment and was complying with its permit by using upstream facilities. Since Kelco's flow went to Point Loma and not upstream, Kelco argued that Point Loma did not remove COD and therefore should not be charged for COD. She said this argument "went on and on." David McKinley from Kelco proposed an alternative structure for those only in the Point Loma system. However, ultimately, all wastewater flowed through Point Loma so the new rate structure needed to be based on a system-wide approach. She said the Group was "slowed down considerably" by Kelco and more meetings had to be held. Other members became sympathetic to Kelco but the technical people were not swayed by McKinley. Ms. Blaskey asked Ms. Keese whether Blair was aware of the Group and its activities. She recalled being told that Kahlie asked Blair if Kelco's alternative was an option. She recalled Blair informing Kahlie that it was not.

Ms. Keese was shown Exhibit 3, a September 28, 2000 email from KeeseCo@aol.com to "wzh" re: "Comments regarding David McKinley." Ms. Blaskey asked Ms. Keese if she remembered the e-mail. She said she did, but did not recall writing it. She said she tried to be fair on the issue of not including COD in the rates. Ms. Keese spoke with Blair and asked him if it was a requirement to include COD and he said, "yes." Ms. Keese said she wanted to know if Blair would accept Kelco's proposal and wanted to hear the answer straight from Blair. Prior to speaking with Blair, it was her understanding from her prior work that COD was not optional. She thinks but can't be sure that as of that time Blair knew the City was not billing for organics.

The Group's Conclusions

Ms. Blaskey asked Ms. Keese to explain the results of the Group's efforts. Ms. Keese said that she supported the City in implementing COD but the Group never truly resolved the COD issue. She said the Group took a vote on allocation methodology which split 6-6 and was sidetracked by McKinley, whom she referred to as "opinionated." Ms. Blaskey asked Ms. Keese about the Group's reaction to the vote. She said there was a lot of frustration, and those who voted against the proposed allocation methodology of the COSS felt they were just forced by the City. Regarding the Group's conclusions, she said ultimately the Group "concluded not to conclude." The six voting against a different methodology proposed by McKinley, agreed to leave it at a deadlock and also agreed to present his method in the Appendix of the Stakeholders' Group Final Report (the "Final Report"). A consultant prepared an analysis of the impact of the consultant's approach, McKinley's approach, and what was currently being charged to each customer class, and incorporated that information in the Final Report. When asked to discuss Exhibit 2 (at bates number SWRCB1304), she said the page discusses the Group's recommendations, and, further, she said that Kelco would be disadvantaged by the proposed method because Kelco had very high BOD.

Ms. Keese said that a second, separate vote was taken directly on whether to approve the proposed methodology of the COSS itself and again the group deadlocked 4-4. Ms. Blaskey asked Ms. Keese what the specific issue was that was voted upon. Ms. Keese responded that the question was whether to approve the specific issue that was reported and its consultant's recommendation, which included COD, for consideration by the Council. She said if there was no majority, the Group could not make a recommendation. Since the vote was split, technically, there was no recommendation. Ms. Blaskey asked Ms. Keese why the vote was not recorded in the Final Report. She said she did not know. Ms. Keese speculated that maybe there was some discussion in the minutes regarding the COSS vote. She felt the COSS vote should have been included in the Final Report. Ms. Blaskey asked Ms. Keese what happened after the Final Report was issued. She said the Final Report was sent out, after the Group disbanded, to the Group and a mailing list. She did not know what was done with the Final Report, whether it went to the Council or not, and did not hear anything about it. At some point, after the Group finished its work but before the City received a 2003 letter from Ron Blair demanding that the City get into compliance with the State's requirements, Ms. Keese asked Hanley about the Final Report, but Hanley did not know.

The Wastewater Subcommittee of the PUAC

Ms. Blaskey asked Ms. Keese to describe her involvement with the Wastewater Subcommittee. Ms. Keese replied that she was placed on the Wastewater Subcommittee through Hanley's efforts and asked to join when the consultant's final COSS was issued, which was when the Wastewater Subcommittee formed in the Fall of 2003. Ms. Blaskey asked Ms. Keese to describe the role of the Wastewater Subcommittee. She said that the Wastewater Subcommittee's role was similar to the earlier Shareholder Group's: to review the COSS, ask questions of the consultant, and make recommendations to the full PUAC, which in turn would make a recommendation to the Council. Ms. Blaskey asked if it was like "déjà vu" having already done this once before, and she agreed that it was. She thought the changes that had been made to the COSS were just updating costs with current numbers since the time period when the Group had finished its work. Ms. Blaskey asked Ms. Keese if the Wastewater Subcommittee

was aware of the Group's earlier work. She said that the Wastewater Subcommittee members might have known about the Group and she recalled discussions in the Wastewater Subcommittee about what the Group had recommended.

Ms. Blaskey asked Ms. Keese for the names of those who participated in the Wastewater Subcommittee. She replied that the Wastewater Subcommittee members she recalled included her, Chairman Scott Chadwick, and David Gomez. According to Ms. Keese, the Subcommittee started paralleling the Group very quickly. She noted that a Kelco representative came to the meetings. McKinley hired Doug Sain to facilitate the process. While Sain was involved with the Wastewater Subcommittee, she did not remember Sain being involved with the Group. Ms. Blaskey asked Ms. Keese whether the Wastewater Subcommittee's discussions differed from the Group's discussions. She responded that there were similar discussions in the Wastewater Subcommittee regarding McKinley's alternative method. She believes the Wastewater Subcommittee listened, sent a copy of the McKinley method to Blair, and Blair said it was not acceptable. The Wastewater Subcommittee voted to approve the COSS and transferred the issue to the PUAC. The Wastewater Subcommittee vote was either unanimous or a majority vote.

Ms. Blaskey asked Ms. Keese whether Blair's 2003 correspondence was received before the Wastewater Subcommittee met. Ms. Keese said Kahlie spoke at the first meeting of PUAC and told them about the deadline provided by Blair in his correspondence and that the State required COD. Ms. Blaskey asked Ms. Keese to describe the involvement of Kelco with the Wastewater Subcommittee and whether it differed from Kelco's involvement with the Shareholder Group. Ms. Keese stated that Kelco's level of participation was consistent with its former participation with the PUAC except for the fact that Sain was involved with the PUAC but was not involved with the Group. McKinley was not on the PUAC but attended meetings as a concerned citizen, as did Sain. Some on the PUAC did not vote to approve the COSS. Ms. Blaskey asked Ms. Keese if Blair was involved with the Wastewater Subcommittee. Ms. Keese recalled that Blair either came to a meeting of the Group or of PUAC. She did not remember Blair specifically addressing COD. She said the PUAC approved the Wastewater Subcommittee's recommendation to implement the COSS.

Proposition 218

Ms. Blaskey asked Ms. Keese whether Proposition 218 was considered by the Group and whether implementing COD/BOD is necessary to comply with it. She replied that Proposition 218 was not considered by the Group and she was not aware that COD/BOD is necessary to comply with Prop 218. She explained that she understood that Prop 218 is a noticing requirement.

Current Responsibilities

Ms. Blaskey asked Ms. Keese if she still consults for the City's PA's. Ms. Keese said she is still a financial consultant to the PA's and she is involved in three tasks: (1) reviewing the annual MWWDD budget of San Diego, including questioning items and helping the PA's understand their charges; (2) involving herself in the auditing process with San Diego including audits regarding tallies of the total cost for capital debt service and O & M and splits out San Diego and PA costs, and engaging in a compliance audit to make sure the PA's are

charged appropriately; and (3) preparing a rate case for the City's own rates including projections of costs. Ms. Keese said she currently works with the City preparing a rate case. Ms. Blaskey asked Ms. Keese who she currently works with in the City on these items. She said she typically works with MWWD Staff, who she said used to be Eric Adachi before he left to work for Chula Vista, but is now Darlene Morrow-Truver. For the independent audit, she works with the Audit/Controller staff and MWWD Staff, including Morrow-Truver, and works with the same people for the annual MWWD budget. Her main MWWD contacts were Bill Hanley and Griffiths and her main Auditor/Controller contacts are Ed Wochaski and Carole O'Hanlon.

Conclusion

Ms. Blaskey requested that Ms. Keese contact her if she recalls any information she believes is relevant to our investigation. Ms. Blaskey requested that Ms. Keese keep the interview confidential.

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